QUESTION PRESENTED

The Commission will discuss the following question: Whether Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder provide a remedy for an agent's fraudulent inducement of a security holder to sell his securities through the agent on the misrepresentation that the agent will return the proceeds of the sale to the security holder.

STATEMENT

The petition seeks review of a decision of the court of appeals which affirmed orders dismissing the complaint for failure to state a cause of action under the federal securities laws. This is an action brought by the Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company ("Manhattan"). Manhattan was a New York corporation engaged in the casualty insurance business and was wholly owned by, but under management separate from, defendant Bankers Life and Casualty Company ("Bankers Life") (Pet. App. 19a). The complaint alleges generally that each of the defendants was a participant in a scheme to defraud Manhattan in connection with certain sales of securities in violation of the federal securities laws (R. 7a–13a). Although the complaint alleged violations only of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), the lower courts also considered

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Court; and it is now inevitable that, if granted, the merits could not be reached until the 1971 Term. The parties were notified that this brief would be filed as soon as the decision to file it was made, on February 18, 1971.

the applicability of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b–5 thereunder, 17 CFR 240.10b–5 (Pet. App. 6a–7a, 34a). See *Hoover* v. *Allen,* 241 F. Supp. 213, 226 n. 7 (S.D. N.Y.).

Specifically, the amended complaint [2] alleges that in January 1962, Bankers Life agreed to sell all the stock of Manhattan to two of the individual defendants in this action—Standish T. Bourne and James F. Begole [3]—for $5 million. (Pet. App. 3a). The purchasers, however, did not pay for the Manhattan stock out of their own funds. Rather, with the aid of the other named defendants, they embarked upon a scheme to use Manhattan's own assets to pay for the purchase of its stock. Simply stated, Bourne and Begole caused Irving Trust Company to issue a check for $5 million on the morning of the closing without any funds to back up the check; on the same day, after securing control, they caused Manhattan to sell $5 million in United States Treasury bonds then in its portfolio, and used the proceeds to cover the Irving Trust Company check.

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[2] For purposes of these proceedings, the complaint is considered as having been expanded by "amendatory allegations presented in open court" which were "not formally set forth in the complaint" (Pet. App. 9a). The motions to dismiss were made five years after the filing of the complaint, and intervening years of discovery were construed by the district court and the court of appeals as having augmented the complaint in the respects thus alleged.

[3] Both Bourne and Begole died prior to petitioner's appeal to the court of appeals; accordingly, they are no longer involved in the proceedings.

Petitioner alleges that Manhattan's board of directors was deceived by some of the defendants into selling these bonds by the misrepresentation that "the sale of the bonds was intended only to effectuate a substitution of those assets for a certificate of deposit equal in value * * *." (Pet. App. 9a). A certificate of deposit for $5 million was obtained in Manhattan's favor; but the certificate was simultaneously pledged as collateral for a $5 million loan in favor of an unrelated corporate entity, making it worthless to Manhattan (Pet. App. 9a). Accordingly, on the basis of the fraudulent representations made to Manhattan's board of directors, "the board was deceitfully induced to authorize the sale of the bonds in exchange for a certificate without value to the corporation" (*ibid*).[4]

On motion the district court dismissed the complaint. 300 F. Supp. 1083 (S.D.N.Y.). The court of appeals affirmed. The affirmance was based in part on questions of petitioner's standing to challenge certain aspects of the fraudulent scheme—questions left open by this Court in *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 467 n. 9, but which the Commission does not here discuss.[5] The affirmance also was

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[4] The court recognized that the board of directors had been deceived: "No doubt the deception was successful, for had the [Manhattan] board [of directors] known that [those in control of Manhattan] intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale [Pet. App. 10a]."

[5] The complaint bases the claim of liability alternatively on three securities transactions, each allegedly part of the overall fraudulent scheme which ultimately led Manhattan to liquidation; but it seeks only a single recovery. (Pet. App. 12a n. 9). The

based on the majority's conclusion, Judge Hays dissenting, that as to the issue on which petitioner did have standing, there was no violation of Rule 10b–5, because the alleged fraud was not "in connection with the purchase or sale of any security."

The majority based this conclusion on the following: (1) the "sole object" of the fraud perpetrated "was to obtain possession of Manhattan's" portfolio securities for the personal use of the perpetrators (Pet. App. 10a); (2) neither the purchaser nor the seller was deceived with respect to the *"terms"* of the sale itself (*ibid.*) (emphasis supplied); (3) the fraud consisted of the failure of those in control of Manhattan to account for the proceeds, and did not affect either the securities markets, the investing public or the terms of the sale (Pet. App. 10a–11a); and (4) there was no danger that the securities sold would be overvalued on reaching the public markets (Pet. App. 11a). In short, the court of appeals found that "[t]he purity of the security transaction [here in issue] * * * [was] unsullied" (*ibid*). In urging this Court to grant certiorari, the Commission

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courts below rejected petitioner's standing to base his claim on two of the three fraudulent transactions, citing *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 463 (C.A. 2), certiorari denied, 343 U.S. 956. Although the Commission disagrees with the rule of *Birnbaum*—as generally stated, that only an actual purchaser or seller of securities may maintain an action under Section 10(b)—it believes (1) that a cause of action has been stated with respect to the sale of Treasury bonds from Manhattan's portfolio; (2) that this cause of action, if recognized by this Court, would provide petitioner with all the relief he seeks; and (3) that it is not clear, even should the purchaser-seller limitation be rejected by this Court, that petitioner should recover for the other transactions that form the focus of his alternative claims.

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discusses only the question whether this conclusion is sufficient to exclude the application of Section 10(b) and Rule 10b–5; or whether those provisions are violated when an agent of a security-holder induces the security-holder to sell his securities through the agent, upon the misrepresentation that the agent will return the proceeds of the sale to the security-holder, and the agent misappropriates the sale for his own use.

THE INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

Within the last decade the antifraud provisions of the federal securities laws, and particularly Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder, have developed into major tools by which to implement Congress' purpose "to prevent frauds in the sale [of] securities sold in interstate and foreign commerce and through the mails" [6] and "to prevent inequitable and unfair practices" [7] in connection with such securities transactions. This Court noted the importance of Section 10(b) and Rule 10b–5 and the public's reliance upon them in *Securities and Exchange Commission* v. *National Securities, Inc., supra*; as Mr. Justice Marshall observed, 393 U.S. at 465, these provisions "may well be the most litigated provisions in the federal securities laws * * *." A major reason for the continually increasing reliance on the federal antifraud provisions has been this Court's refusal to adopt restric-

[6] Preamble, Securities Act of 1933, 48 Stat. 74.

[7] Preamble, Securities Exchange Act of 1934, 48 Stat. 881.

tive constructions and limitations upon these and analogous antifraud provisions,[8] both in Commission enforcement actions and in private actions which serve as a "necessary supplement" to the Commission's own actions. *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432.

The Commission has a central responsibility to maintain the integrity and scope of these remedies. The rule of law established by the court below poses a serious threat to these antifraud provisions by formalistically and narrowly defining, and severely circumscribing, the scope of the securities transactions to which they apply. Cf. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 379.

DISCUSSION

The question whether Section 10(b) and Rule 10b–5 provide a remedy for an agent's fraudulent inducement of a security-holder to sell his securities through the agent, upon the misrepresentation that the agent will return the proceeds of the sale to the security-holder, is important and recurrent. It was wrongly decided by the court of appeals, in conflict with the decisions of other courts of appeals, the administrative interpretation by the Commission of its own rule, and principles enunciated by this Court. The issue thus merits review by this Court.

1. The central importance of the case is in its interpretation of the language of Section 10(b) and Rule

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[8] See *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195; *Tcherepnin* v. *Knight*, 389 U.S. 332; *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*, 393 U.S. 453; *J. I. Case Co.* v. *Borak*, 377 U.S. 426; and *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375.

10(b)–5 which limits their application to conduct "in connection with the purchase or sale of any security." The court of appeals construed this language to restrict these provisions to cases in which the alleged wrongdoers are shown to have the purpose of defrauding securities investors, as distinct from a purpose merely to loot a corporation's assets. The Commission does not believe the language is so limited; in its view, the phrase does no more than confine Section 10(b) to cases in which securities are involved as distinct from fraudulent conduct generally.

a. The lower courts' restrictive construction conflicts with the principle that securities legislation should be construed without regard to technical and restrictive notions of intent "but flexibly to effectuate its remedial purposes." *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc., supra,* 375 U.S. at 195; see also, *Tcherepnin* v. *Knight, supra,* 389 U.S. at 336; cf. *Ellis* v. *United States,* 206 U.S. 246, 257. The "in connection with" clause "is plainly and—one must assume—intentionally the loosest linkage, in any of the federal antifraud provisions, between a proscribed act and a security transaction." Bromberg, *Securities Law: Fraud-SEC Rule* 10*b*-5, Sec. 7.6(1), p. 190.21. See, *e.g., Herpich* v. *Wallace,* 430 F. 2d 792 (C.A. 5), certiorari denied, March 1, 1971, No. 1078, this Term; *Kahan* v. *Rosenstiel,* 424 F. 2d 161, 172 (C.A. 3), certiorari denied *sub nom. Glen Alden Corp.* v. *Kahan,* 398 U.S. 950; *Hooper* v. *Mountain States Securities Corp.,* 282 F. 2d 195 (C.A. 5), certiorari denied, 365 U.S. 814. Section 10(b) and Rule 10b–5 are applicable irrespective of the dominant motivation, once fraud in a securities

transaction has been shown.[9] Cf. *Capital Gains Research Bureau, supra,* 375 U.S. at 200–201.

b. The court of appeals' opinion raises serious questions of fidelity to Congress' purpose in enacting Section 10(b). That section was intended to be as broad as the Act itself, serving to fill any gaps left by more specific provisions in preventing "cunning devices." Hearings on H.R. 7852 and 8720, *House Committee on Interstate and Foreign Commerce,* 73d Cong., 2d Sess. 115; see also H. Rep. No. 1383, 73d Cong., 2d Sess. 6. The legislative purpose was broad; the wording of the section is correspondingly broad; and the scope of the rule adopted by the Commission to enforce it is intended to be equally broad. "It would have been difficult to frame the authority to prescribe regulations, in broader terms. Had Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so. We see no reason to go beyond the plain meaning of the word 'any,' indicating that the use of manipulative or deceptive devices or contrivance of whatever kind may be forbidden * * *" *Rekant* v. *Desser,* 425 F. 2d 872, 880 n. 15 (C.A. 5). With the exception of the decision below, the courts have generally rec-

[9] See *Kohler* v. *Kohler Co.*, 319 F. 2d 634 (C.A. 7); *Myzel* v. *Fields*, 386 F. 2d 718 (C.A. 8); Bromberg, *Securities Law: Fraud—SEC Rule* 10b–5, Sec. 7.2(4)(e) and 7.6(2)(a), pp. 154.2 and 190.24. Indeed, prior to this opinion, the Second Circuit had unequivocally recognized that motive is irrelevant in determining whether Rule 10b–5 has been violated. *Heit* v. *Weitzen*, 402 F. 2d 909, certiorari denied, 395 U.S. 903; *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833, certiorari denied *sub nom. Coates* v. *Securities and Exchange Commission*, 394 U.S. 976.

ognized that by the enactment of Section 10(b) Congress intended to prevent inequitable and unfair practices and to ensure fairness in securities transactions generally, whether conducted in the organized securities markets or face-to-face. *Matheson* v. *Armbrust,* 284 F. 2d 670, 674 (C.A. 9).[10]

Indeed, the securities legislation of 1934 was based in large measure on congressional dissatisfaction with rules of the New York Stock Exchange that made the unlawfulness of stock pools turn on proof of motive. As the Senate Committee stated, "Motive furnishes no justification for the employment of manipulative or deceptive devices."[11] It is difficult to believe that the same Congress that considered these stock exchange rules to have been "emasculated by the inclusion of restrictive phraseology"[12] would have intended its own legislation to be read in such a restrictive manner.

2. While it might at first appear troublesome that the securities fraud committed here also occurred in connection with or as a part of internal corporate embezzlement, and that the corporation itself is the defrauded "investor," these circumstances neither detract from the importance of the case nor foreclose petitioner's claim. Section 10(b) and Rule 10b–5 extend pro-

[10] See also, *Herpich* v. *Wallace*, *supra*, 430 F. 2d at 806; *Rekant* v. *Desser*, 425 F. 2d 872 (C.A. 5); *Kahan* v. *Rosenstiel*, *supra*; *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5), certiorari denied, 365 U.S. 814. On prior occasions the Second Circuit has adopted this expansive approach to the purpose and coverage of Section 10(b) and Rule 10b–5. See *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, *supra*, 401 F. 2d at 847–848; *Heit* v. *Weitzen*, *supra*.

[11] S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), p. 32.

[12] *Id.* at 49.

tection to "any person," and Section 3(a)(9) of the Securities Exchange Act expressly includes "a corporation" within the definition of a "person." *Hooper* v. *Mountain States Securities Corp., supra,* 282 F.2d at 202. Securities fraud committed in connection with internal corporate affairs remains securities fraud nonetheless. While Congress did not intend to regulate transactions which comprise no more than internal corporate mismanagement, it acted to protect securities investors from all forms of securities fraud, even if corporate looting was the motivating factor or an additional result of the securities fraud perpetrated.[13] Actions instituted by the Commission also bear out this philosophy;[14] the lower court's opinion is in conflict with the numerous court decisions[15] holding that a misappro-

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[13] See, *e.g.*, *Herpich* v. *Wallace; supra; Rekant* v. *Desser, supra; Pappas* v. *Moss*, 393 F. 2d 865 (C.A. 3); *McClure* v. *Borne Chemical Co.*, 292 F. 2d 824 (C.A. 3), certiorari denied, 368 U.S. 939; *Errion* v. *Connell*, 236 F. 2d 447 (C.A. 9).

[14] See, *e.g.*, *Securities and Exchange Commission* v. *Bowler*, 427 F. 2d 190 (C.A. 4); *Securities and Exchange Commission* v. *Fifth Avenue Coach Lines*, 289 F. Supp. 3 (S.D. N.Y.), affirmed, CCH Fed Sec. L. Rep., para. 92,880 (C.A. 2); *Securities and Exchange Commission* v. *Parvin Dohrmann Co., et al.*, 69 Civ. 4543 (S.D. N.Y.).

[15] *Securities and Exchange Commission* v. *Federal Shopping Way*, Civ. Action No. 7351 (W.D. Wash.), affirmed, 433 F. 2d 148 (C.A. 9); *Securities and Exchange Commission* v. *Bowler, supra;* 427 F. 2d 190 (C.A. 4); *Los Angeles Tr. D. & M. Exch.* v. *Securities and Exchange Commission*, 285 F. 2d 162 (C.A. 9), certiorari denied, 336 U.S. 919; *Stevens* v. *Vowell*, 343 F. 2d 374 (C.A. 10); *Hooper* v. *Mountain States Securities Corp., supra; Securities and Exchange Commission* v. *Culpepper*, 270 F. 2d 241 (C.A. 2); *United States* v. *Monjar*, 147 F. 2d 916 (C.A. 3), certiorari denied, 325 U.S. 859.

priation of funds resulting from a securities sale is within the purview of Section 10(b) and Rule 10b–5.[10]

3. The decision below also conflicts with *Hooper* v. *Mountain States Securities Corp., supra,* 282 F. 2d 195 (C.A. 5), in holding that application of these antifraud provisions was foreclosed once it was conceded that there had been no misrepresentation regarding the investment value of the Treasury bonds sold. See also *Errion* v. *Connell, supra; Stevens* v. *Vowell, supra;* cf. *Mills* v. *Electric Auto-Lite, supra.* The requirement of misrepresentation as to investment value is a novel one, which raises a serious question whether the court of appeals has not exalted form over substance. *Securities*

[10] Almost since the Commission was established, application of Section 10(b) and Rule 10b–5 to misappropriation of investors' funds has been particularly prominent in its regulation of broker-dealers registered with it. See, *e.g., Securities and Exchange Commission* v. *Lawson*, 24 F. Supp. 360 (D. Md.); *Globe Securities Co., Ltd.*, 10 SEC 1105. While it could be urged that the special obligations of broker-dealers to their customers form the basis for the imposition of sanctions for conversion of a customer's securities, (see *e.g.*, Section 8 of the Securities Exchange Act, 15 U.S.C. 78h, and Rule 8c–1, thereunder, 17 CFR 240.8c–1), it may be questioned whether such broker-dealer obligations are any more compelling than the obligations of insiders and controlling shareholders to their corporation. See, *e.g., Speed* v. *Transamerica Corp.*, 99 F. Supp. 808 (D. Del.). And the Commission has generally alleged that such conduct also violates the antifraud provisions of the federal securities laws. In light of the recent concern over brokerage house failures, it is important that no aspect of the Commission's enforcement arsenal be impaired. Cf. *Securities and Exchange Commission* v. *Charles Plohn & Co.*, CCH Fed. Sec. L. Rep., para. 92,843 (C.A. 2); *Securities and Exchange Commission* v. *First Devonshire Corp.*, S.D. N.Y., 70 Civ. 3752; *Securities and Exchange Commission* v. *Robinson & Co.*, E.D. Pa., Civ. Action No. 70–2396.

and Exchange Commission v. *National Securities, Inc.*, *supra*, 393 U.S. at 465. Its decision seriously restricts the reach of the antifraud provisions of the securities laws. This is an important question which should be settled on a national basis through review by this Court.

CONCLUSION

In view of its position on the question discussed, the Commission believes that the petition for a writ of certiorari should be granted.

Respectfully submitted.

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